

## Cash Basis Sales Tax Audit Overview

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### Introduction

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This document contains basic information on standard audit procedures and descriptions of common audit work papers for cash basis sales tax audits. The following information is intended to assist taxpayers in understanding the process for this type of audit. Audit procedures and work papers will vary depending on the facts and circumstances of each individual audit. The purpose of any audit is to verify the payment of tax in accordance with the act under which they are remitted.

Michigan Treasury Department protects the confidentiality of your personal and business information collected during the tax examination. All financial records collected during the cash basis audit are confidential and protected from disclosure by Section 205.28(1)(f) of the Revenue Act. Improper disclosure by state employees is a felony and punishable by fines and/or imprisonment.

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### Basic Audit Steps:

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#### 1. Preliminary Audit Information – At the start of the audit, Treasury will:

- Provide you with an Audit Confirmation Letter, which sets the audit commencement date.
- Provide you with a copy of the Michigan Department of Treasury's brochure, "Taxpayer Rights During a Cash Basis Audit".
- Ensure that you are aware that we require signed Power of Attorney forms prior to any outside contact with your CPA, attorney, bookkeeper, etc. regarding your account(s).
- Ensure that you are aware of your right to contact the Auditor's Team Manager, Audit Manager, and/or Administrator regarding audit issues.

#### 2. Field Interview and Store Survey

The purpose of the field interview is to allow the auditor to see first hand how the store is set up. The auditor will ask you for a description of your business including the number of locations and their activities and whether your business has experienced any changes in activity or ownership in the past four years. In addition, the auditor will ask questions about the types of products sold in your store, your vendors,

your sales tax reporting procedures, and the business's daily operations. During the field interview, the auditor may:

- Inspect the cash registers for type, key coding, and usage.
- Ask for an X-ring to verify sales categories and taxability.
- Review procedures for ringing up or scanning merchandise.
- Review internal controls.
- If a scanner is used, the auditor may review the UPC listing.
- Observe product prices and the store layout.

#### 3. Record Keeping

The auditor will discuss where and how your records are maintained. All records should be maintained for a period of 4 years after the due date of the return or after the date the return was filed, whichever is later (MCL 205.27a(2)). The auditor will take the available records and schedule a date to retrieve additional records if necessary.

#### 4. Review of records – After the auditor has received the requested records, the auditor will:

- Verify reporting procedures for gross sales, deductions and tax collected/paid. Reported sales tax information is transcribed on Schedule X.
- Verify gross sales.
  - Compare sales reported on the sales tax returns with the federal returns, monthly sales journals, profit & loss statements, and cash register tapes. This comparison is shown on Schedule G. Profit and loss statement sales are transcribed onto Schedule G1. Federal return information is transcribed on Schedule G2. Sales tax return information is shown on Schedule X. Differences in sales among the various reports are reconciled and any necessary adjustments to gross sales are made on Schedule B.
  - Review markups on merchandise sales. Schedules E1, E2, E3, E4, E5, E6, and E7 are used to compute markups.
- Verify Purchases.
  - Compare purchases reported on the profit & loss statements with the federal returns, invoices, and vendor checks. These comparisons are shown on Schedules D and F. Purchases from the profit & loss statements are transcribed onto Schedule F1.

- Complete a purchase spread for a test (sample) period using monthly purchase invoices provided by the taxpayer. The purchase spread shows the volume and ratios of inventory purchased by category (food, prepared food, liquor, cigarettes, beer & wine, other) that is available for sale in the store. Information provided by vendors and government agencies, such as the Michigan Liquor Control Commission (MLCC), may be used to ensure the completeness of the purchase spread. The auditor will conduct vendor checks when deemed necessary. Purchase spread invoice detail is transcribed on Schedules D1 and D2. Totals from the purchase spread are entered onto Schedule D by category.

- Test (sample) periods are selected using a random number generator. The random number generator outputs 3 random months. You are then given the option to select 2 of the 3 months or select one of the random months and a second month that immediately precedes or follows the random month selected. Months chosen for the test period should represent normal business activity. Consecutive months are recommended to eliminate timing differences.

- **Verify Deductions.**

- Deductions are verified to the taxpayer's records including the monthly sales journals, profit & loss statements, vendor checks (such as the Michigan Bureau of State Lottery), and cash register tapes.

- The food deduction is verified by tests performed including the purchase spread. The purchase spread is used to determine the percentage of food purchased compared to total merchandise purchased. A comparison of the audit determined food percentage and the percentage of food for human consumption deduction reported on the sales tax returns is shown on Schedule C6.1. A reported food deduction that is higher than the amount determined by the auditor will result in disallowed deductions. The determined food for human consumption deduction is calculated on Schedule C6. Product markups, when available, are factored into this analysis on Schedule E5.

- Adjustments to deductions are shown on Schedule C.

**5. Audit Conclusion - In order to conclude the audit:**

- Auditor may request additional records at any time during the audit. We appreciate your cooperation in providing the auditor with complete records when requested. In the event that complete records are not provided, the audit will be conducted using the best information available, which may result in the use of projections or the disallowance of deductions

- Auditor may ask the taxpayer to reconcile or explain differences noted in the records provided.

- Auditor will complete audit schedules and summaries.

- Auditor will review the completed audit with the

taxpayer or the taxpayer's representative.

- Upon request, the taxpayer will be provided with the appropriate copies of law, rule, or court decision to support any audit changes.

- Any final adjustments will be made to the audit schedules based on additional documentation provided by the taxpayer.

- Auditor will provide final copies of the audit schedules to the taxpayer. The final audit package will include a Notice of Preliminary Audit Determination that should be signed and returned to the auditor.

- All audits are subject to review by supervisor, audit manager, and auditing and taxing divisions.

- The taxpayer will receive a Final Audit Determination Letter mailed directly from Lansing when processing of the audit is complete.

- If you are not in agreement with the audit determination, please read the Final Audit Determination Letter carefully as it contains information on your appeal rights.

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## **Records Required for Audit**

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Records should be maintained for a period of 4 years after the due date of the return or after the date the return was filed, whichever is later (MCL 205.27a(2)).

- Annual Returns for Sales, Use and Withholding Taxes with Supporting Schedules and Monthly Worksheets

- Federal Income Tax Returns and Supporting Schedules (including amended returns or IRS audit adjustments)

- Michigan Tax Returns and Supporting Schedules (SBT/MBT/CIT)

- Federal and State Individual Income Tax Returns and Supporting Schedules

- General Ledgers

- Profit & Loss Statements (by month, by category)

- Daily Sales Records

- Cash Register Tapes

- Sales Journal or Other Records Showing Accumulation of Total and Taxable Sales

- Customer Exemption certificates (if applicable)

- Purchase Invoices

- Bank Statements and Cancelled Checks
- Check Register and Stubs
- Monthly Cigarette Buy down Documentation from Cigarette Manufacturers
- Physical Inventory Reports
- Categorical Mark-up Worksheet.

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## **Descriptions of Sales Tax Schedules**

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### **Schedule A – Audit Summary**

- Shows a breakdown of sales tax, interest, and penalty due for each year of the audit period.

### **Schedule A1 – Determination of Deficiency**

- Shows the calculation of sales tax due based on audit determined sales and deductions.
- Compares reported and determined sales tax.
- Shows amounts of audit adjustments made to sales and deductions.

### **Schedule A2 – Penalty & Interest Calculation**

- Shows the interest rates and calculation.
- Shows the penalty rate and calculation.

### **Schedule B – Determined Gross Sales**

- Shows gross sales reported per the sales tax returns.
- Shows audit adjustments made to reported gross sales.

### **Schedule B1 – Audit Sales Based on Markup**

- Shows the calculation of audit determined sales based on audit determined purchases and markups.

### **Schedule B2 – Computation of Liquor Sales**

- Shows the liquor selling price based on purchases from the Michigan Liquor Control Commission (MLCC). Liquor sales are removed from gross sales to determine the net merchandise sales on Schedules C6 and C6.1.

### **Schedule C – Summary of Deductions**

- Shows reported deductions and audit determined deductions on a yearly basis.

### **Schedule C6 – Food for Human Consumption**

- Shows the calculation of the allowable food deduction. The allowable food deduction is calculated by multiplying net merchandise sales by the audit determined food percentage. The audit adjustment is calculated based on the difference between the reported and determined food deductions.

### **Schedule C6.1 – Food Percentage from Taxpayer Records**

- Shows the sales and food deductions reported on the sales tax returns.
- Calculates the reported percentage of food deduction compared to net merchandise sales.
- Shows the audit determined food deduction percentage and shows the difference between the reported and determined food percentages.

### **Schedule D – Percentages from Auditor's Purchase Spread**

- Shows sample period purchase totals broken down into the following categories: liquor, beer & wine, cigarettes, other taxable items, food, and prepared food.
- Shows net bottle deposit amounts that are removed from the purchase totals so only merchandise purchase totals remain.
- Shows adjustments to the purchase spread for items such as vendor checks, cigarette rebates, missing invoices, etc.
- Compares purchase spread totals to purchases recorded in the taxpayer's records for the sample period.
- Calculates the food percentage of non-liquor purchases.

### **Schedule D1 – Purchase Spread (Vendor Invoices by Code by Envelope)**

- Shows purchase invoices from the sample period transcribed by category.

### **Schedule E1 – Pre-Audit Markups**

- Calculates markup percentages on COGS (cost of goods sold), purchases, and non-liquor purchases based on the taxpayer's records.

### **Schedule E2 – Post-Audit Markups**

- Calculates markup percentages on COGS, purchases, and non-liquor purchases after audit adjustments to sales, purchases, and deductions.

### **Schedule E3 – Liquor Markups**

- Compares the liquor purchases per MLCC to liquor sales per the taxpayer's record to determine if the markups are in agreement with the MLCC prescribed markup (17.5529%).

### **Schedule E4 – Observed Markup**

- Shows the average categorical markups obtained

from the categorical markup worksheet prepared by taxpayer.

#### **Schedule E5 – Observed Markup Analysis**

- Uses the average categorical markups (Schedule E4) and purchases from the purchase spread (Schedule D) to calculate projected sales.
- Compares projected sales to the sales per the taxpayer's records for the sample period.
- Shows calculated markups on sample period purchases and projected sales for comparison purposes with the overall and non-liquor markups calculated on Schedules E1, E2, or E7.

#### **Schedule E6 – Categorical Markup**

- Calculates markups by category (liquor, beer & wine, cigarettes, general taxable, food, and prepared food) based on the taxpayer's sales and purchase records.

#### **Schedule E7 – Federal Return Markup**

- Calculates overall merchandise markup and non-liquor merchandise markup based on federal return gross sales and COGS.

#### **Schedule F – Purchases Comparison**

- Shows comparison of purchases per federal return, COGS, and records.
- Compares liquor purchases per MLCC and per records.

#### **Schedule F1 – Purchases Transcript from Taxpayer Records**

- Shows transcript of monthly and/or annual purchases by category from the taxpayer's records.

#### **Schedule G – Sales Comparison**

- Shows comparison of gross sales per federal return, SBT/MBT/CIT returns, monthly sales journals, transactional records, and monthly/annual sales tax returns. Shows Michigan Lottery Commissions and Sales.
- Shows Michigan Lottery Commissions and Sales.
- Compares liquor sales per MLCC and per records.

#### **Schedule G1 – Transcript of Sales from Taxpayer Records**

- Shows transcript of monthly and/or yearly gross sales by category from the taxpayer's records.

#### **Schedule G2 – Transcript of Federal Returns**

- Shows transcript of federal income tax returns.

- Shows transcripts of information from Michigan agencies including the Bureau of State Lottery and the Department of Natural Resources.

- Shows information from SBT/MBT/CIT returns.

- Shows information from individual income tax returns.

#### **Schedule W – Tax in Excess**

- Shows tax reported per transcript (Schedule X) compared to tax collected/accrued.

#### **Schedule X – Transcript of Monthly Sales Tax Reported @ 6%**

- Shows transcript of monthly sales tax returns.

#### **Schedule Z – Cite References**

- Shows statutory cite references for audit adjustments made.

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### **Reference Materials**

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The following references are meant to provide statutory guidance with regards to the Department's treatment of certain types of sales and/or purchases made by a taxpayer.

#### **Deductions / Taxability of Commonly Sold Items**

- RAB 2009-8 Food for Human Consumption
- MCL 205.73(4) - Enrichment
- MCL 205.73(5) – Cigarettes: cannot separately state on the invoice tax imposed by the tobacco tax act. MCL 205.51 states that purchase price does not include separately stated taxes.
- MCL 205.52(2)(b) – Phone Cards
- Taxability Matrix – information on phone cards/ telecommunications

#### **Records**

- MCL 205.67
- MCL 205.68
- MCL 205.104
- MCL 205.104a
- R205.23 Records

#### **Penalties**

- RAB 2005-3 Penalty Provisions
- R205.1013 Failure to file or pay penalty; waiver of penalty; reasonable cause for failure to file or pay.
- IPD 2008-3 Frivolous Protest Penalty.